Compliance of Islamic Finance to Run a Sharī'ah-Based Economy in Pakistan

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Abstract

The Islamic Finance organizes financial services in accordance with Islamic Law. The purpose of this paper is to identify the unique challenges facing Islamic finance in compliance with Islamic law in the ambit of conventional system of banking and finance, and putting the case of Islamic finance as a role model. Islamic finance has its basis in using transaction types which are in accordance with Sharī'ah principles like prohibition of ribā, gharar (an unacceptable level of risk), maysir (gambling), and forbidden things, such as wine, blood and idols. The background of Islamic finance with its roots from the era of Prophet (PBUH) and a relationship in devising tools of financial transaction in comparison with conventional system are part of this study, giving an insight into Islamic financial Law. The concentration of Islamic finance has been in Persian Gulf and Southeast Asian countries in its phase of origin but later it expanded globally and shown high growth rates in international market. There are opposition faced by growth of Islamic finance on the grounds that it has a hidden agenda to counter US economic sanctions and having terrorist financing or political agendas. While the advocates deny all such assumptions and put the argument that it is an alternate method to generate capital and provision of navel business opportunities and economic progression.

Keywords: Islamic Finance, Sharī'ah-Based Economy, Pakistan.

Introduction

Islam has the unique principles integrated for a complete code of life. Islamic financial mechanism cannot be understood in isolation as socio-economic pattern is the basis of Islamic economics. A dynamic model presented by Ibn Khaldūn (15th Century) state a précis for an Islamic financial system:

> "The strength of the sovereign (al-mulk) does not become consumed except by implementation of the Sharī'ah; The Sharī'ah cannot be implemented except by a sovereign (al-mulk); The sovereign cannot gain strength except through the people (al-rijāl); The people cannot be sustained except by wealth (al-māl); Wealth cannot be acquired except through development (al-'imrān); Development cannot be attained except through justice (al-'adl); Justice is the criterion (al-mīzān) by which God will evaluate mankind; and The sovereign is charged with the responsibility of actualizing justice."[1]

Islamic Economics is based on divine law, Sharī'ah, comprising rules from Qur'ān and Sunnah; that's why it is different from other prevalent economic systems and their issues. Sharī'ah principles have instructions for all facets of life ranging from religion, politics, business, economics and law.[2] Islamic finance has shown a rapid increase in its growth and emerged significantly recently.[3] It has successfully been operated in Muslim and non-Muslim countries worldwide. Modern Islamic finance continues living worldwide since 1970s. Islamic finance symbolizes a small but significantly growing division in the global finance, ranging upwards from $ 800 billion and with a growth rate of 10 % to 15 %

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annually over the past ten years.[4] Presently, Global Islamic Finance Report 2014 estimates the size of the global Islamic financial services industry at $1.813 trillion at the end of 2013. This represents 12.3% annual growth over 2012, an increase of $182 billion in absolute terms.[5] Financial principles of Sharīʻah focus on proscription of interest, contractual uncertainty, share in risk and profit, encouragement of principled investments that develop society, and asset backing.[6]

Islamic Financial Reforms in Historical Perspective:

At the emergence of Islam in Arabia, local Arabs were very much accustomed to trade and commerce and utilize comparatively intricate financial mechanism to get done with their financial needs. On the other hand, the trade used to employ quite manipulative and exploitative principles. The holy Prophet (PBUH) brought a number of reforms in restructuring and improvements while making use of compatible approaches in dealing with it. He also made certain modifications in the manner of trade, while encouraging Muslims to work hard and become economically strong.

The basic line of reasoning of the holy Prophet (PBUH) includes reforming the existing financial system and infrastructures by altering the outlook regarding wealth, its making, management and dissemination. Secondly, he emphasized that real ownership belongs only to Allah Almighty. Wealth is a trust (amānah) from Allah and everyone shall be accountable as obligated because of one's moral or religious conscience. The factors like honesty, transparency and justice as well as protecting the rights of others and of society and state at large are the key determinants in wealth transactions.

Origin and Development of Islamic Banking and Finance Systems:

Islamic finance is financial intermediation achieved so as to comply with the strongly rooted Islamic principles expressed in the Sharīʻah.[7] The origin of Islamic banking and finance systems was the foundation of meeting the needs that were previously fulfilled by conventional system by the use of Islamic modes of dealings in order to facilitate Muslims to conduct business, expand wealth and progress islamically.

Islamic forms of finance are practiced in variant forms since early history of Islam, but it remained dormant from late nineteenth till late twentieth century; showed slow resurgence in 1960s when two Islamic banks were inaugurated in Egypt (1963) and Malaysia (1967)[8] and later showed great pace till the start of twenty first century. More than 250 financial Institutes commission worldwide in 75 countries with an estimated asset size of $800 billion to $1 trillion and a growth rate of 10-15 % per annum. This growth of Islamic finance is bridging the gap between Islam and the West in an effective manner.[9]

A continued effective growth and sustainable development of Islamic financial system needs a regulatory framework that evaluates the financial transactions in the light of Sharīʻah principles to see their compliance or otherwise in the opinion of Jurists, done effectively through Sharīʻah advisory board.

Islamic finance though practiced in different countries, where they either modified their existing laws or developed unique Islamic banking regulations, but a global Islamic finance law is yet to be developed. A comprehensive legal structure with effective substantive and regulatory laws must be formulated by competent lawyers and judges with sound knowledge of Sharīʻah, for making it readily available globally.[10]

Growth of Islamic Finance in Gulf region and south-east Asia has made it a financial hub of Islamic finance due to its rapid growth and acceptability. Iran, Saudi Arabia, Malaysia,

Kuwait and UAE are the major financial markets in Sharīʻah compliant banking and finance. In the Middle East, Libya and Morocco do not show much growth as they are refused licenses due to political reasons or else factors but Jordan, Tunisia and Sudan have shown tremendous response to Islamic financial system being an alternate means to financial transactions and economic growth.[11]

In Europe and America too, there has been significant reception to Islamic finance. In United Kingdom (UK) in 2004, Islamic Bank of Britain (IBB) was established with a license from Financial Services Authority (FSA) serving Sharīʻah compliant products.[12] In 2006 European Investment Islamic bank was also established regulating independent Sharīʻah compliant investments. Sharīʻah compliant finance in USA has been much in use in home mortgages[13]; HSFC provides Islamic finance services in USA. International financial intermediaries also provide Sharīʻah compliant services in USA. More than 70 indices are maintained by the Dow Jones in its Islamic series; advised by independent Sharīʻah supervisory council.[14] The International Monetary Fund (IMF) shows that Islamic banking seems to be a complement to conventional banks, rather than a substitute.[15]

Characteristics of Islamic Finance:

The significant characteristics of Islamic finance spell out the rationale and role of Islamic finance worldwide. ***Firstly***, Islamic financial system signifies shared ownership and stake-taking. It functions using system of inconsistent turnover on actual production. ***Secondly***, Islam changed the affiliation of economy from credit-based to justice based and stake-taking. It is an innovative modification and calls for new approach to the economy; because inequitable distribution is the root cause of exploitation. ***Thirdly***, Islamic framework is distinguished by moral standard and communal pledges and allegiance. The *halal* (permissible) and *haram* (prohibited) moral filter plays the crucial role. ***Fourthly***, Islamic finance is friendly to the entrepreneurs, heading for growth and development of economic production and services. Islamic framework adopts distributive justice approach that ensures diffusion of resources to grass-roots and community development. ***Fifthly***, Islamic system is non-inflationary. It restores equilibrium between three variables, fiscal growth, wealth resource and corporeal development of economy. These characteristics make Islamic system of finance as distinct and unique. Its variant dimensions fortify and cultivate democratic character, making it a justice-targeted socio-economic system. Islamic finance is a justifiable manifestation of philosophy to make use of wealth. Being an important part in emerging economies, Islamic finance has much to gain in the international financial markets.

Prevailing Islamic Financial Models :

The Sharia set up distinctive Islamic theories to ascertain the connection between profit and risk, money and capital; and link and responsibilities between financial institutions and individuals. The Holy Qur'ān strictly forbids interest (*ribā*) in order to avoid the manipulation via use of money in profit and share loss. Money is not an asset that grows itself with time; rather it is just a mean to exchange. Prohibition of dealing with goods like alcohol, pork, weapons has also the underlying principle of Sharīʻah of not benefitting on unjustifiable grounds. Islam believes on justified share of profit with no interest that will lead to long-term relationship and its consequences.

For that purpose, three distinct models are functional throughout the world. ***Firstly***, interest free banks, companies and financial institutions that have some share of financial deposit by government or financial institutions. This category includes *al-Barakah* and *Dār*

al-Māl al-Islāmī. ***Secondly***, riddance of ribā' within the existing system by establishing interest-free banks in private sectors and then extending it to whole banking sector. Pakistan, Iran and Sudan started working on this project but there are still many mileages to achieve to reach the goal. ***Third*** model is a combination of both, i.e. establishing a ribā -free banking system within state sponsored legal system; and creating a mechanism by which a ribā -free window is established in conventional banks. That is how both systems co-exist and compete with one another. This model is prevalent in Malaysia.

Islamic Financial Instruments and their Application:

The contemporary financial system is associated with many positive and negative implications, however when calculating pros and cons, the failures overshadow and out-number.[16] It has been established since long that conventional banking is un-Islamic but the judgment of how to deal with it, took a long time to get a proper ruling. Majority of jurists allowed continuing with conventional system on the basis of need. This ruling was based on legal maxim that achieving the benefit and removing the harm is the basic purpose of Sharī'ah. Thus it was facilitation of people to lift the prohibition on the basis of absence of any alternate system. Later with the renaissance of Islam and initiation of Islamic banking and finance the ruling of religious scholars changed and they prohibited any dealings with conventional banking system.[17]

Islamic banks have developed many products founded on risk and profit sharing beliefs. These products comply with the Islamic set of guidelines, and make available acceptable returns for financier. They are the means to an end in Islam. Today the most common forms are: ***(a) Murābaḥa***, where the Islamic bank purchases goods, takes title, and then re-sells these to a member at an agreed mark-up, or on deferred payment. ***(b) Murābaḥa***, a business finance arrangement where the Islamic bank provides capital for a business venture, and receives a percentage of the businesses profits. ***(c) Mushāraka***, a project where the bank enters into a partnership with a client where both share the equity capital and management. Profit or loss sharing is on the basis of equity shareholding. ***(d) Ijāra, (leasing)*** where assets are purchased by the bank, and leased, and an arrangement of deferred payment is made by the member. ***(e) Takāful***, (insurance) is a procedure employing reciprocated collaboration and assistance, unity, and camaraderie against unexpected risk or devastation. Parties contribute genuinely, and to pool their resources, in order to donate compensation to the aggrieved party when the insured event occurs. Funds are invested in projects acceptable under the Sharī'ah. ***(f) Muqāraḍa***, where a banks floats Islamic bonds to finance a project, and members obtain a percentage of the profits (or losses) of the project, and ***(g) Salim***, where a purchaser pays, beforehand, a specific amount of a product at an agreed price.

In any financial system, money has the crucial role used primarily as a means of exchange and criterion for delayed payments. Economic progress and development is indicated through an extension of human and physical summative of economy through creation of assets, products and services. A legal or ethical relationship of trust between two or more parties for financial matters is not a criterion for measuring financial expansion. The two processes as a result of which monetary collaboration takes place are direct investment and financial intermediaries' channel, both legal under Islamic structure. Islam permits both on justifiable grounds that a preset stipulated profit on capital, loan-able funds or credits is prohibited; it has to be variable depending on functioning of the project, which is just for both parties. Islamic finance supports the construction of societal significance in conjunction

with monetary worth because it has at its essence the notion of risk-sharing transaction, explicitly mentioned, making it sustainable and acceptable amongst market of different approaches. Ijāra and holders of a sukūk are its examples. In the beginning PLS products were introduced with new genre in order to coincide to traditional risk and return synopsis. Islamic finance advocates Profit Loss Sharing (PLS) as its theoretical pedigree and "promotes risk-sharing between investor and the entrepreneur, which is one of it significant feature."[18]

> "Any neutral observer can see the problems the above [Capitalist banking] system causes on a macro basis in any economy. Islamic finance operates a system called Mushāraka which ensures that the above inequalities do not occur…. Mushāraka lies at the heart of the Islamic Financing philosophy, where the notion of sharing in risk and return between investors and entrepreneurs finds its natural home".[19]

In order to establish the existing contracts into the folds of Islam, initially the elements which are not in accordance with Islamic principles should be affirmed invalid and should not invalidate whole contract. Secondly, if the practicing of any of the products violates Islamic principles, it should be declared discarded and instead, Islamic modes like Mushāraka and Muḍāraba should be promoted. The profit and loss sharing (PLS) system is based on Mushāraka and Muḍāraba in which depositors, bank and user share a PLS relation. The fundamentals of Islamic banking system include risk-sharing, transaction of goods in physical, and conducting trading, leasing and contracting under the umbrella of Islamic finance modes. Thus in Islamic finance, assets are not used as medium to gain predetermined profit that involves no risk; though it is a relevant factor. Islamic Finance is associated with concepts of impartiality, justice and neutrality which are recognized by Sharīʻah permitting debt-creating financing while prohibiting interest-based lending and any addition which is interest-based.[20] Interest (ribā) must be eliminated from all transactions and new Islamic contracts may be introduced, like ḥawālah, istithnā etc.

A careful scrutiny shows that many Islamic contracts take place as continuation of business practices before the advent of Islam. These practices were modified and un-Islamic elements were deleted to make it compatible with Islamic teachings; sale, ijārah, Salam, Muḍāraba, and Mushāraka are to name a few. This shows that modification and alteration is not un-Islamic, as it had been approved through Sunnah. Therefore, to adapt, imitate or replicate is not culpable provided that Sharīʻah rules are followed. Thus, Sharīʻah based products are at par with Sharīʻah compliant products. Both are Islamic, provided that they comply with the rulings for valid product. So it's not about Islamic/ un-Islamic it's about serving and reaching the purpose better.

Application of Islamic Finance in Pakistan:

Islamic finance is emerging globally from mere theoretical concept to a practical reality. Many challenges come across during the progression both on intellectual and practical avenues. The philosophical foundations and principles of Islam is emphasized on one end while the diversity of regulatory, supervisory and legal environments faced by Islamic financial institutions; the standardized framework; corporate governance; and availability of new genre of Islamic financial products are the challenges on practical front. These challenges need a balanced approach between theory and reality on strong standpoint.

Islamic banking and finance is the ultimate desire of Muslims that popped out of their efforts to search the ways and means for a ribā free financial system based on principles of Sharīʻah. Many

scholars put their efforts in the sub-continent and Egypt initially to dig deep into the intellectual grounds to lay the foundations for a practical Islamic finance system working without ribā.[21] Pakistan is ranked number eight among 50 countries worldwide including Iran, Malaysia, Saudi Arabia, UAE and Sudan for its efforts in progress, development and advocating Islamic banking and finance by Edbiz Consulting in Islamic Finance Country Index (IFIC).

Islamic banking and finance was launched in Pakistan in 1970s as a result of continued efforts for elimination of *ribā* from the economy. A number of significant measures were employed in the wave of evolution of this system till mid-80s, however it did not materialized well on account of various factors including lack of effective Sharīʻah compliant mechanism, and a flexible evolutionary approach. But this exercise provided a valuable experience utilized in commencement of strategic plan by State Bank of Pakistan for gradual implementation of Islamic financial system. In 2001, a high rank meeting of President of Pakistan with Governor State Bank of Pakistan, Chairman Islamic Ideological Council and many other dignitaries, it was decided to make a gradual shift of economy from conventional system to Islamic system without causing any chaos. Henceforth, the framework designed by SBP comprise of (a) Sharīʻah Board at SBP (b) Sharīʻah Advisor (c) Essentials and Model agreements of Islamic modes of Financing Instructions and guidelines for Sharīʻah Compliant Islamic financial institutions (d) Sharīʻah Advisory Forum (e) Standardization of Sharīʻah Practices.[22]

State bank of Pakistan later on formulated a 'Strategic Plan-Islamic Banking Industry of Pakistan (2014-2018). This strategic plan is devised for constructing a future roadmap as well as for identifying the issues and challenges to be resolved for growth and development of industry to the next level. This plan also emphasizes on Sharīʻah standardization and harmonization for making Islamic finance a competitive and permissible financial system.[23] The three tiered approach is articulated permitting establishment of new full-fledged Islamic banks, allowing separate Islamic Bank subsidiary within conventional banks and approving stand-alone branches of Islamic banking for conventional banks. This change of perspective from legal and regulatory approach to managing Sharīʻah compliant products and instruments has picked a very encouraging response.

The key points of this strategic plan stress on the following areas.

a) ***Enabling Policy Environment***, legal, regulatory, supervisory, liquidity management framework, taxation regime and financial accounting & reporting framework; ***(b) Sharīʻah Governance & Compliance***, standardization and harmonization of Sharīʻah practices, and creating distinct Islamic banking products and services; ***(c) Awareness and Capacity Building***, efforts for coordination and collaboration amongst internal and external stakeholders, enhancing awareness about Islamic finance, and building capacity of the stakeholders; ***(d) Market Development***, product diversification and financial inclusion with the collaboration of stakeholders.

The stability and resilience exhibited by Islamic financial industry in Pakistan in the wake of financial crisis has earned an acknowledgment of being a feasible and competitive element of the finance system. Pakistan has shown a marked progress in Islamic banking and finance i.e. 30 % which is above the average global growth rate.[24] The strategies formulated by State Bank of Pakistan for growth of Islamic finance propose doubling the Islamic bank branches for increasing the market share as of 10 % to 15 %. Proviso Islamic banks show signs of Greenfield growth, higher than the development in conventional sector, Pakistan will turn

out to be the most important participant in Islamic banking and finance, being the second largest Islamic market (population-wise) after Indonesia.

Rationale for Closely Related Products and their Influence:

Understanding of Islamic finance is based on Sharīʻah Compliant and Sharīʻah Based perspectives. Sharīʻah compliant means asset based perspective that means asset are operated in a manner that the outcome of Islamic products resemble conventional banking products, like tawarruq, ʻInah and wa'd total return swap be coupled with conventional index, ijāra, ṣukūk etc. Islamic products are structured in the same pattern as conventional banking products to make a reference that it would get acceptance to its similar conventional product. Thus Islamic products are introduced with new genres.

Sharīʻah based means knowhow of formulation and innovation of products work i.e. when the products transaction is 'real' and not used as a conduit (medium) for obtaining output like conventional banking. New products are formulated without making point of reference to conventional products as they may or may not bear a resemblance to them in its structure or features; new products would use Islamic contracts like murāsala, takāful.

As a matter of fact, if Islamic products would use the conventional products as standard and replicate the services, they will need to use assets in the same manner as conventional manner to achieve the same output. While if Islamic products work in isolation employing real transactions, real asset will also be involved leading to performance of transaction interrelated to asset. If Islamic finance will follow the patterns of conventional mode, and keep replicating them, it will make Islamic finance vulnerable to same issue for which conventional system is criticized thus leading to incredibility of Islamic products as they had only changed the name not the substance.

It is argued that masses are familiar with financial tools of conventional banking, thus it will make them understand and accept the Islamic tools with much ease. It is assumed that closely related products will help in development of Islamic group and enhancement of market share as Islamic and conventional systems work parallel to each other. There had been certain reservations on Islamic framework of taxation and legal arena and Islamic banking and finance was taken as an area that needs more expertise and capability and working on conventional system was more easy and un challenging, creating less chaos.

As a result of closely related products with conventional systems, there is duplication of conventional products with new genre and new Islamic products are structured on the basis of a review of profitable products so that they look like conventional products already followed. New Thus newly introduced products resemble in essence, substance and result with the conventional products, though they are different technically and legally. Due to above mentioned impacts, many advocates of Islamic finance show reservations to Islamic banking.

Conclusion :

The framework of Islamic finance system is based on elements of Sharī'ah (Islamic Law) which prohibit Ribā (Usury) and Gharar (Deception) permit risk sharing and stress heavily on the values like fairness, honesty, avoidance of hoarding, and all such transactions which are forbidden by Sharīʻah. The fundamental concept is that the money has no inherent value and should be used as a measure of worth. One impact of the financial crises worldwide, has been the rise of Islamic Finance because its resilience to such crises. Economy and Religion do not mix and Islamic Finance is not a religious system, its open for all people Muslim and non-Muslims to make money ethically. Thus, a standard regulatory and legal framework must be

institutionalized for devising body of laws and regulations which are in accordance with Sharī'ah principles. A distinct and precisely determined body of rules must be formulated for future development and progress in international markets which requires standard procedures and broad financial accounting systems. The present research acclaim that Sharī'ah Law, Sharī'ah Complaint and Sharī'ah based finance, risk mitigation policies and procedures, nature of Islamic contract, Sharī'ah Advisory Board (SAB), and the growth of Islamic finance in the GCC must be given due consideration in the Islamic finance system for proper implementation as a role model for running economy.

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